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CMA Water Price Determinations Provisional Findings Cost of Capital and Cost of Debt Consultation Response

Introduction

Owned by pension funds, IFM Investors is one of the largest infrastructure investors globally, with more than £36bn of infrastructure equity assets managed worldwide. Drawing upon our 25+ years investing in the sector, we focus on buying high quality, essential infrastructure businesses which form the backbone of economies and societies. 98% of our investors are pension funds, including 50 here in the UK, which means the returns that we generate go towards supporting millions of pension members. Those returns rely on receiving stable, predictable cash-flows over long periods of time. Any major changes to these cash-flows are ultimately to the detriment of the pensioners that we represent.

As a shareholder in Anglian Water since 2006 we have supported the business in investing over £9bn into new infrastructure. We are proud of the company's hard-earned reputation as one of the leading companies in the sector, delivering for its customers and the communities it serves every day.

Cost of Capital – Working Papers

The CMA provisional findings in respect of water price controls published in September 2020 re-established the importance of the underlying principles of financeability in the water sector and correctly identified errors made by Ofwat in their Final Determination for Anglian Water. The principles on the cost of capital acknowledged the risk investors take and the need for continued investment in the sector, and went some way to respect Department for Environment, Food and Rural Affairs (Defra)'s strategic policy statement (SPS), which requires the regulator to "sustain long term investor confidence in the sector with the aim of protecting customer interest". Nevertheless, the provisional findings presented a potential redetermination that fell significantly short of the company's PR19 business plan that the board had approved and which Anglian Water customers and key stakeholders had endorsed. We are therefore very concerned to see in the recently published CMA working papers changes that would further reduce the cost of capital. This would have an adverse impact not only on our pension fund investors, but also our customers and the environment.

Cost of Debt

The Board of Anglian Water have a duty to act in the best interests of all stakeholders. For our customers, that means certainty of bill profile, a high quality of service, and investment to support resilience. Anglian Water customer's bills are 15% lower (excluding inflation) than they were 20 years ago despite being in the driest region in the UK with the fastest rate of population growth outside of London. Anglian Water's ability to deliver £9bn of investment over

the past 20 years has been achieved in part through use of long dated debt on the company's balance sheet, consistent with Ofwat's guidance in PR99 that securing long dated debt was in the best interests of customers over the long term.

In the latest working paper on cost of debt, reductions in the look-back period to 15 years are being proposed. This would fail to cover the overall investment horizon and create a situation where older, efficiently incurred debt is now unfunded - it is unclear why the CMA has shifted position so materially on this point, which introduces an unwelcome retroactive aspect to regulation. This, if not redressed, will undermine the transparency and consistency provided by the UK's long established, incentive-based and independent regulatory framework.

Regulators should be encouraging the use of longer-term financing to underpin the increased investment in water and wastewater infrastructure necessary for it to meet its duties to customers and to wider society, not least in the context of the UK's commitment to net zero by 2050.

Cost of Equity

The regulatory framework is required to balance the financing duty, customer objectives and investment in resilience. The demands of the UK's net zero legal commitment increasingly loom large outside of the five-year framework, with Anglian Water customers particularly focused on investment in the resilience of their water supply.

The assumption of there being limited risk of capital exiting (based in part on incorrect assertions made by Ofwat on investor sentiment founded on incomplete evidence) is inconsistent with our view. Historically, investors were attracted to the water sector in the UK due to the stability of the regulatory framework. This stability was undermined by the PR19 Price Review and was one of the reasons why Anglian Water has asked the CMA to redetermine. The provisional findings from the CMA helped restore some level of confidence, however the significant change of course signalled in the latest consultation casts doubt on the stability and long-term attractiveness of the sector. In our opinion, this risks engendering a mentality of short-termism, which will prove extremely detrimental to all stakeholders.

The working papers acknowledge that on the balance of risk the incentive regime set by Ofwat will see negative ODI related returns on average. This asymmetry will undoubtedly be further exacerbated by COVID-19 which has seen extreme pressure placed on the operations of the business, the outcome of which is yet to be fully captured - given we are currently still in a national lockdown – but is only getting more challenging.

Over time, if there continues to be unexpected changes to the way regulators determine the cost of capital, trust will be eroded, and investors will channel capital to more stable environments. The proposed 0.25% reduction in the cost of equity alongside all the asymmetric incentives regime being proposed does cause concern for not just AMP7, but signals a worrying trend for future AMPs.

Impact on Customers & the Environment

Turning to the broader issues the CMA is considering as it moves towards concluding its work, we are concerned that the interests of customers and the environment in the East of England may not be well reflected in the positions the CMA has indicated it may take.

Following an extensive PR19 customer engagement programme - which was acknowledged by Ofwat as industry leading - Anglian Water customers and stakeholders told the company that they wanted to see more investment for the future. Customers consistently placed greater emphasis on ensuring investment to address growing and urgent climate change impacts, rather than having a short-term bigger reduction in bills. That is why the Board approved the most ambitious business plan to date featuring a refreshed Strategic Direction Statement and 25-year Water Resource Management Plan.

To see little evidence of this having been recognised by the CMA, with bill reductions appearing to take precedence over much needed investment puts into question the purpose of mandating companies to undertake this research in the first place.

We hope these comments are helpful to you as you consider the balance that needs to be struck in your final redetermination.

Yours sincerely



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